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BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of)

Treatment of Local Exchange Carrier)
Tariffs Implementing Statement of)
Financial Accounting Standards,)
"Employers Accounting for)
Postretirement Benefits Other Than)
Pensions")

CC Docket No. 92-101

Bell Atlantic Tariff F.C.C. No. 1)

Transmittal No. 497

US West Communications, Inc. Tariff)
F.C.C. Nos. 1 and 4)

Transmittal No. 246

Pacific Bell Tariff F.C.C. No. 128)

Transmittal No. 1579

TO THE COMMISSION

DIRECT CASE OF
SOUTHWESTERN BELL TELEPHONE COMPANY

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June 1, 1992

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Direct Case of
Southwestern Bell Telephone Company

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Transmittal No. 246
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SUMMARY*

SWBT's Direct Case shows that the costs associated with the implementation of SFAS-106 should be recognized as exogenous under the Commission's price cap rules.

The Bureau has already authorized all local exchange carriers to adopt SFAS-106 accounting on or before January 1, 1993, using the amortization method of recognizing the Transition Benefit Obligation. The Bureau concluded that SFAS-106 is consistent with the Commission's regulatory objectives. Nevertheless, the Commission has indicated that GAAP changes will be examined on a case-by-case basis to determine whether they are eligible for exogenous cost treatment. The key factor in determining whether exogenous cost treatment is warranted is whether the GAAP change is reflected generally in the GNP-PI.

The Godwins Study clearly shows that the GNP-PI does not reflect the SFAS-106 change to the same extent as it impacts local exchange carriers. Under the Commission's case-by-case evaluation, the Godwins Study thus shows that SFAS-106 costs should be eligible for exogenous cost treatment.

There are no other reasons to deny exogenous cost treatment for SFAS-106 costs. SWBT is actively working to minimize health care costs, the key portion of OPEBs. The actuarial assumptions used by SWBT, and the assumptions used in the Godwins Study, are reasonable. In fact, less conservative approaches to the analyses would probably find that more of the costs of OPEBs should be treated as exogenous.

*All abbreviations used herein are referenced within the text.

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DIRECT CASE OF
SOUTHWESTERN BELL TELEPHONE COMPANY

Southwestern Bell Telephone Company (SWBT), pursuant to the Order of Investigation and Suspension released April 30, 1992 by the Common Carrier Bureau (Bureau) of the Federal Communications Commission (Commission),¹ hereby files its Direct Case.

I. INTRODUCTION

Prior to Divestiture and well before the subsequent debate and development of the eventual price cap plan for LECs, both the LECs and the Commission realized that accrual accounting for the nonpension benefits provided to retirees would have to be adequately addressed under any form of regulation.

¹Treatment of Local Exchange Carrier Tariffs Implementing Statement of Financial Accounting Standards, "Employers Accounting for Post Retirement Benefits Other Than Pensions" CC Docket No. 92-101; Bell Atlantic Tariff F.C.C. No. 1, Transmittal No. 497; US West Communications, Inc. Tariff F.C.C. Nos. 1 and 4, Transmittal No. 246; Pacific Bell Tariff F.C.C. No. 128, Transmittal No. 1579; Order of Investigation and Suspension (DA 92-540) (released April 30, 1992) (Investigation Order).

The Commission explicitly recognized the need to allow rate recovery for extraordinary cost changes imposed by GAAP changes in its Second Further Notice.² Subsequently, in the LEC Price Cap Order, LECs were notified that carriers would be allowed to reflect GAAP changes in their price caps after the GAAP changes were approved.³ Based upon these orders, SWBT expected that approved GAAP changes would be treated as exogenous cost adjustments in the price cap formulas. Given the magnitude of the effect of accrual accounting for nonpension retiree benefits, SWBT would have strenuously objected to the Commission's price cap plan without this assurance. It would be arbitrary and capricious to fail to recognize this effect in LEC price caps at this time.

This Direct Case demonstrates that the GAAP change imposed on SWBT for implementation of SFAS-106 should be recognized as an exogenous cost change under the Commission's price cap rules. The Commission should therefore allow a fair level of rate recovery of the increased interstate regulated costs imposed on SWBT by the mandatory implementation of SFAS-106.

II. BACKGROUND

The Financial Accounting Standards Board (FASB) prescribed that SFAS-106 be effective for fiscal years beginning

²Policy and Rules Concerning Rates for Dominant Carriers, 4 FCC Rcd. 2873 (1989) (Second Further Notice) at para. 654.

³Policy and Rules Concerning Rates for Dominant Carriers, 5 FCC Rcd 6786 (1990) (LEC Price Cap Order) at para. 168.

after December 15, 1992, with earlier application encouraged.⁴ Thus, in 1990, the FASB concluded a thorough 12-year examination of this issue.

Postretirement benefits other than pensions (OPEBs), were first addressed by the FASB in 1979 as part of its project on accounting for pensions. The FASB was concerned about the lack of financial statement information regarding costs and obligations for OPEBs.

After examining OPEBs within the context of its project on pensions, the FASB identified accounting for OPEBs as a separate project in 1984. As an interim measure, the FASB issued SFAS 81, "Disclosure of Postretirement Health Care and Life Insurance Benefits." In April 1987, the FASB issued Technical Bulletin 87-1, "Accounting for a Change in Method of Accounting for Certain Postretirement Benefits," to provide temporary guidance to employers making a voluntary change in their method of recognizing OPEB cost. This Technical Bulletin provided guidance on how certain companies could change their methods of accounting for OPEBs. The FASB issued an Exposure Draft on proposed OPEB accounting on February 14, 1989. In a final pronouncement in December 1990, the FASB prescribed a standardized accrual accounting basis for OPEB recognition to replace the current prevailing cash-based recognition of such costs.

SFAS-106 recognizes OPEBs as a form of deferred

⁴Statement of Financial Accounting Standards No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions" (SFAS-106), December 1990, para. 108.

compensation, earned by employees as they provide service to the employer. Recognition of OPEBs over the relevant employee service period is accomplished under the principles of accrual accounting. With SFAS-106, the FASB applied the same accounting principles used to determine pension expense under SFAS-87, "Employers' Accounting for Pensions." The accounting prescribed in SFAS-106 was determined to improve employers' financial reporting of OPEB in the following manner:

- (1) Cost will be recognized as employees render the services necessary to earn the benefits;
- (2) The employer's financial statement will include measures of the OPEB obligation;
- (3) Financial reporting and related disclosures will enhance users' understanding of the extent and effect of these benefits; and
- (4) Implementation of the Standard will improve comparability of financial results by requiring employers with similar plans to measure costs and liabilities using the same accounting methodology.

The amount accrued as the cost of OPEBs for a period is the net periodic postretirement benefit cost. The components of net periodic costs defined by SFAS-106 are:

- (1) Service Cost which represents the portion of the OPEB Expected Postretirement Benefit Obligation (EPBO) earned by employees during the current accounting period. The EPBO is the actuarially determined present value measured at a particular date of the OPEB expected to be paid by SWBT on behalf of its employees;
- (2) Interest Cost which is the product of the assumed discount rate times the beginning of the year accumulated postretirement benefits obligation (APBO). The APBO represents the portion of the EPBO earned to date as a result of past employee service. Interest cost represents the increase in discounted plan liabilities that occur as a result of the passage of time;

- (3) Actual Return on Plan Assets which is a reduction to net periodic cost and recognizes the return on plan assets permanently set aside to satisfy future plan obligations;
- (4) Amortization of Unrecognized Prior Service Costs which represents the ratable recognition of the cost of plan amendments that increase or decrease benefits attributable to prior periods;
- (5) Amortization of Gain or Loss Deferred which represents the ratable recognition of the net effects of prior years' unrecognized gains and losses. Gains and losses may be either changes in the amounts of the APBO or the plan assets that have resulted from experience different than that assumed or from changes in assumptions;
- (6) Amortization of the Transition Obligation which represents the ratable amortization of the unrecognized net OPEB obligation (i.e., the extent to which the APBO exceeds the Plan assets) existing at the initial application date of the final Standard.

On December 26, 1991, the Bureau authorized all subject carriers to adopt SFAS-106 accounting on or before January 1, 1993, using the amortization method of recognizing the transition obligation.⁵ Since the FASB had required the adoption of SFAS-106 and because the Bureau did not mandate otherwise, SFAS-106 accounting must be used for SWBT's interstate operations.⁶

⁵Southwestern Bell, GTE Service Corporation Notification of Intent to Adopt Statement of Financial Accounting Standards No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions, 6 FCC Rcd. 7560, (1991, Com. Car. Bur.) (SFAS-106 Adoption Order).

⁶Revision of the Uniform System of Accounts for Telephone Companies to Accommodate Generally Accepted Accounting Principles, 50 F.R. 48408, November 25, 1985.

III. IMPLEMENTATION OF SFAS-106 RESULTS IN AN EXOGENOUS COST CHANGE.

The Bureau concluded in the SFAS-106 Adoption Order that adoption of SFAS-106 would be consistent with the Commission's regulatory objectives.⁷ This finding indicates that SFAS-106 costs are an appropriate regulatory cost of service. The increase in revenue requirements caused by SFAS-106 fits the Commission's definition of exogenous costs:

Exogenous costs are in general those costs that are triggered by administrative, legislative or judicial action beyond the control of the carriers. . . [and] that should result in an adjustment to the price cap in order to ensure that the price cap formula does not lead to unreasonably high or unreasonably low rates.⁸

FASB-mandated accounting changes are beyond the control of SWBT and must be considered to be exogenous costs.

The Commission has indicated that it will evaluate GAAP changes on a case-by-case basis to determine eligibility for exogenous cost treatment under price cap regulations.⁹ The key factor in determining eligibility is whether the cost of a particular GAAP change will be reflected in the GNP-PI, the inflation variable in the price cap index.¹⁰ The Commission has

⁷SFAS-106 Adoption Order, at para. 3. The SFAS-106 GAAP change has been explicitly incorporated into the FCC's Part 32 accounting rules. RAO Letter 20, released May 4, 1992.

⁸LEC Price Cap Order at para. 166.

⁹Policy and Rules Concerning Rates for Dominant Carriers, 6 FCC Rcd 665 (1991) (AT&T Price Cap Reconsideration Order), at para. 85.

¹⁰Policy and Rules Concerning Rates for Dominant Carriers, 6 FCC Rcd. 2637 (1991) (LEC Price Cap Reconsideration Order), at para. 63; Bell Atlantic Telephone Companies Tariff F.C.C. No. _____, (continued...)

stated that:

If a GAAP change is universal enough to be reflected in the inflation measure, exogenous cost treatment would result in double counting within the context of the PCI.¹¹

On the other hand, in cases where a GAAP change is not reflected in the GNP-PI or where only a small portion of the costs associated with such a change are reflected in the GNP-PI, it follows that exogenous cost treatment is the only lawful alternative.

Failing to allow exogenous cost treatment for a GAAP change when only a small portion of its costs are reflected in the GNP-PI would unfairly and unlawfully penalize carriers for administrative agency (i.e., FASB and regulatory) decisions beyond their control and would be an arbitrary and capricious dismantling of the exogenous cost framework which is central to the Commission's price cap plan for LECs. Exogenous treatment is a fair and equitable means of rate recovery for the resulting increases in interstate revenue requirements.

A. SFAS-106 Effects Are Not Fairly Recovered By Changes In The GNP-PI.

The United States Telephone Association (USTA) engaged Godwins, Inc. to perform a study to determine the extent to which

¹⁰(...continued)
Transmittal Nos. 492 and 502, Order, (DA 92-335) (released March 18, 1992) at fn. 2. (Bell Atlantic sought exogenous cost recovery of the effect of an increase in the Public Utility Realty Tax assessed in Pennsylvania, and argued that it was not accounted for in the GNP-PI. Notwithstanding that petitioners opposed this argument, the Bureau found no compelling reason to warrant rejection or investigation.)

¹¹LEC Price Cap Reconsideration Order at para. 63.

the effects of SFAS-106 would be reflected in the Commission's price cap mechanism.¹² A copy of this study is included as Exhibit 1.

The Godwins Study was divided into two parts: an actuarial analysis and a macroeconomic analysis. The actuarial analysis included all LECs operating under the Commission's price cap plan for LECs.¹³ Data from these companies was used to construct a composite company reflecting the characteristics of the industry as a whole. The study's macroeconomic analysis examined the effects of SFAS-106 on the U.S. economy and specifically determined its effects on the GNP-PI measure used as the inflation adjustment in the LEC price cap plan. This analysis considered both the direct effects of SFAS-106 costs and its indirect effects on U.S. average wage rates.

The Godwins actuarial analysis, which was a very conservative approach, indicates that SFAS-106 will increase direct labor costs to the average employer in the U.S. economy by a fraction of the increased cost to price cap LECs.¹⁴ Specifically, the macroeconomic portion of the Godwins Study determined that only

¹²See, United States Telephone Association, "Analysis of Impact of SFAS No. 106 Costs on GNP-PI", (Godwins Study) February 1992, p. 1.

¹³This segment of the LEC industry had total 1990 revenues of \$82.5 billion and employed approximately 613,000 employees and provided postretirement benefits to another 294,000 retired employees. See Godwins Study, p. 6.

¹⁴This is due in large part to Godwins showing that only 30.7 million private sector employees out of 95.8 million are eligible for some coverage of their retirement medical costs. The increase in labor costs for the average employer in the U.S. economy is only 28.3% of the increased labor cost to price cap LECs.

a small portion, 2%, of the average U.S. employers' direct SFAS-106 costs would be reflected in the GNP-PI. Moreover, price cap LECs would only be able to recover 0.7% of their additional SFAS-106 costs through the price cap inflation adjustment mechanism.

Thus, the Godwins Study shows that SFAS-106 costs are also not double counted in the GNP-PI, at least as to 99.3% of these costs.

An additional finding was that SFAS-106, under certain conditions, could have a downward effect on the national average wage rate. If the price cap LECs actually experienced the lower wage rates estimated in the Godwins Study, they would recover at most an additional 14.5% of their SFAS-106 costs through this possible and indirect effect. The following table summarizes the direct and indirect effects of SFAS-106:

Maximum Telco Recovery of SFAS 106 Costs
Without Exogenous Cost Recovery
(Godwins Study Results)

	Percent of Telco <u>Incremental SFAS-106 Costs</u>
GNP-PI Effect	0.7%
National Wage Effect	<u>14.5%</u>
Total Effect	15.2%

This table shows that under the extremely conservative approach in the Godwins Study, at least 84.8% of price cap LECs' incremental SFAS-106 costs will not be recovered through the price cap inflation adjustment mechanism without exogenous cost treatment. Thus, the majority of SWBT's increased interstate costs caused by SFAS-106 should be treated as an exogenous cost under the

Commission's price cap rules. Based on the Godwins Study, SWBT currently proposes that 84.8% of its SFAS-106 costs be treated as exogenous.

At each juncture in Godwins' analysis, where an assumption was needed, Godwins selected an assumption that disadvantaged the LEC industry by reducing the requested proportion of SFAS 106 cost that would be requested as exogenous. A primary example of this conservatism in the Godwins Study is the assumption that all firms, importantly those in unregulated markets, have not already made whatever adjustments to prices are necessary or possible to reflect the economic costs of OPEBs. The Godwins Study assumes that all employers who offer postretirement health benefits will experience an increase in the cost of labor at the exact same time as do the price cap LECs. This assumption is obviously false, but it works against price cap LECs and was made in a spirit of conservatism.¹⁵

Further, the extensive sensitivity analysis presented in the Godwins Study demonstrates that the 84.8% result is very conservative.¹⁶ Page 41 of the Godwins Study presents a summary of the sensitivity analysis and illustrates the robust nature of the Godwins results with respect to a range of possible assumptions

¹⁵See also, "The Treatment of SFAS-106 Accounting Changes Under Price Cap Regulation," April 15, 1992, prepared by the National Economic Research Associates, Inc., submitted with the Pacific Bell Transmittal No. 1579 in this docket. "Because prices in unregulated markets already reflect the economic costs of postretirement benefits, adoption of SFAS-106 will not cause them to change." (p. 3)

¹⁶See Godwins Study, pp. 34-43.

that clearly bracket any reasonable view of reality.

For these reasons, SWBT contends that 84.8% of the SFAS-106 costs is the lowest appropriate exogenous cost adjustment; more reasonable estimates would be significantly higher than 84.8%.

B. The SFAS-106 Expenses Are A Real Cost Of Doing Business.

On December 26, 1991, the Bureau authorized all subject carriers to adopt SFAS-106 accounting on or before January 1, 1993, using the amortization method of recognizing the transition obligation.¹⁷ The Commission has previously recognized that it would incorporate changes in generally accepted accounting principles (GAAP) provided that such changes do not conflict with its regulatory objectives.¹⁸ Cost of service/revenue requirement as calculated for regulatory purposes generally follows GAAP as evidenced by Part 32 of the Commission's Rules.¹⁹ Thus, GAAP is the preferred method of accounting for financial and regulatory purposes.

Accordingly, SFAS-106 accounting is an appropriate measure for determining expenses related to OPEBs. This method is now the generally accepted standard in the American business community and should be the appropriate method for use in determining price cap indexes.

Accrual accounting is consistent with fundamental

¹⁷SFAS-106 Adoption Order at para. 3.

¹⁸See, fn. 5, supra.

¹⁹47 C.F.R. Section 32.16.

ratemaking theory which is premised on the fact that costs and benefits should accrue to the generation of customers responsible for the costs and benefits. Accordingly, SFAS-106 recognizes that an employee earns OPEBs over their service life and that the employer should recognize its expense of providing OPEBs during the same period.

C. SWBT Has Minimized Health Care Costs, The Key Portion Of OPEBs.

Some commentators may claim that only a portion of the costs of OPEBs should be considered exogenous since these costs are an area where price cap companies should be expected to institute additional cost controls. SWBT, however, has done all that could reasonably be expected to minimize these costs. As an example, SWBT has engaged in a progressive method of minimizing health care costs.

Like most companies in the U.S., SWBT has had to deal with rapidly rising health care costs. SWBT, in conjunction with The Prudential Insurance Company of America (Prudential) and various other insurance carriers, developed the CustomCare plan. CustomCare controls costs without automatically shifting them to plan participants. Instead, CustomCare offers participants choices and the opportunity to take a more active role in their health care. At the same time, the plan gives health care providers incentives to improve quality of care and maintain optimal standards. Exhibit 2 provides a review of the CustomCare plan. Several newspaper and magazine articles from various publications are also provided that highlight the economic benefit of the

CustomCare plan.

From a financial perspective, CustomCare has been very successful. SWBT has controlled its health care costs as compared to the national average as shown below:

- From 1987 to 1988 the per employee claims cost increased by 12 percent compared to the national average of over 20 percent.
- From 1988 to 1989, the increase was 7 percent compared to a 22 percent national average.
- And in 1990, the increase was 11 percent, compared to the national average of 22 percent.

IV. THE COMMISSION HAS ESTABLISHED A PRECEDENT FOR RECOVERY OF OPEB COSTS ACCOUNTED FOR ON AN ACCRUAL ACCOUNTING METHOD.

The Commission has allowed LECs operating under both rate of regulation and price cap regulation to obtain interstate rate recovery of OPEB costs using an accrual accounting method rather than pay-as-you-go.

The Commission did not preclude price cap LECs from interstate rate recovery of accrual accounting for OPEB expenses, although the Part 32 Rules required pay-as-you-go accounting. LECs that accrued such expenses generally set up funding through VEBA Trusts in accord with existing accounting rules. In the LECs' 1990 Annual Access Tariff Filings, the Commission addressed these expenses, and generally, the OPEBs expenses were allowed.²⁰ SWBT understands that at least five of the 11 price cap LECs and at least one LEC under rate of return regulation are currently

²⁰Annual 1990 Access Tariff Filings, 5 FCC Rcd 4177 (1990) paras. 305-310. (Disallowances associated with out-of-period 1989 OPEB expenses were made in two study areas.)

recovering some amount of accrual accounting for nonpension retiree benefits in their current interstate rates.

The Commission has further summarized its position on the accrual of expenses prior to SFAS-106 implementation:

The OPEB expenses some LECs have embedded in their July 1990 rates were introduced pursuant to existing accounting rules that permitted LECs, at their option, to change their accounting treatment of OPEB expenses. Carriers that chose to accrue OPEB expenses were not more right or wrong than carriers that chose to await the GAAP change. Under the rate of return regulatory structure, as long as the carrier's costs are reasonable and prudent, these costs can be used in the ratemaking process to justify rates.²¹

Given the Commission's stated position on the accrual of OPEB expenses, the Commission should now allow interstate rate recovery for LECs who chose to await the GAAP change.

V. EXOGENOUS COST TREATMENT SHOULD BE ALLOWED FOR SFAS-106 COSTS PRIOR TO JANUARY 1, 1993.

The Commission has not precluded price cap LECs from receiving exogenous cost treatment of SFAS-106 prior to January 1, 1993. While the Bureau denied an AT&T request for an exogenous cost adjustment of \$196 million for a switch to accrual accounting for OPEB, the ruling was based on the fact that neither the FASB nor the Commission had yet mandated the GAAP change:

Neither the language of the rule [Section 61.44(c)(2)], or the language of the Price Cap Order enable AT&T to claim as exogenous a proposed change in GAAP or USOA.²²

²¹LEC Price Cap Reconsideration Order, para. 61.

²²AT&T Transmittal No. 2304, 5 FCC Rcd 3680 (1990) at para. 4.

In the LEC Price Cap Order, the Commission established the standard for the timing of LEC exogenous cost treatment of USOA amendment and GAAP changes.

No GAAP change can be given exogenous treatment until the Financial Accounting Standards Board has actually approved the change and it has become effective. The price cap mechanism is intended to reflect changes that have occurred, not anticipated cost changes.²³

Finally, the LEC Price Cap Reconsideration Order reemphasized the prior timing standard:

Our decision not to consider exogenous treatment of GAAP changes, including OPEB expenses, until the GAAP change becomes effective is one grounded in the orderly administration of our price cap system. The requirement ensures that we will not be called upon to render decisions prior to the time FASB has made a final ruling Carriers that elected to wait until the GAAP change becomes effective before expending funds for OPEB are not necessarily foreclosed from recovering these costs. Instead, we will consider request for exogenous treatment at that time.²⁴

Thus, the Commission ensured that price cap LECs will be able to have a reasonable opportunity to recover SFAS-106 costs once the FASB had made a final ruling. That final ruling was released in December, 1990,²⁵ and explicitly encouraged early implementation.

²³LEC Price Cap Order, para. 168. In the AT&T Price Cap Reconsideration Order, however, the Commission modified the standard for AT&T's request of exogenous cost treatment of GAAP changes:

We decided that we should take more seriously the absence of clarity on the question of possible double-counting, and evaluate GAAP changes on a case-by-case basis. AT&T Price Cap Reconsideration Order, paras. 74-75.

Nevertheless, this order did not change the standard regarding the timing of an exogenous cost adjustment for a GAAP change. Id.

²⁴LEC Price Cap Reconsideration Order, paras. 59-63.

²⁵See, fn. 3, supra.

The SFAS-106 ruling was allowed to be incorporated into the Commission's Rules in December, 1991.

VI. SWBT-SPECIFIC SFAS-106 DATA

The following SWBT-specific data, descriptions and justifications are provided in response to the Investigation Order.

A. SWBT Has Not Yet Determined The Date That SWBT Intends To Implement SFAS-106.

SWBT is currently analyzing the most appropriate time for implementation of SFAS-106. While SWBT has not ruled out 1992 adoption, there are no plans to implement SFAS-106 prior to January 1, 1993.

B. SWBT's SFAS-106 Costs By Year Have Been Calculated.

SWBT's interstate SFAS-106 costs by year for 1992 through 1996 are shown below:

**Postretirement Benefits Other Than Pensions
Interstate Revenue Requirement Study
Annual Incremental Impact of SFAS-106²⁶**

	(\$ Millions)				
	<u>1992²⁷</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>
1. Total SFAS No. 106 Accrual	91.3	91.3	96.7	99.4	101.7
2. Pay-As-You-Go Amounts ²⁸	30.8	34.8	37.6	40.5	43.2
3. Existing Trust Contributions	<u>0.0</u>	<u>0.0</u>	<u>0.0</u>	<u>0.0</u>	<u>0.0</u>
4. Total Current Accounting	<u>30.8</u>	<u>34.8</u>	<u>37.6</u>	<u>40.5</u>	<u>43.2</u>
5. Incremental Expense	60.5	56.5	59.1	58.9	58.5
6. Incremental Rate Base Impact	<u>(3.5)</u>	<u>(8.5)</u>	<u>(17.2)</u>	<u>(23.9)</u>	<u>(30.6)</u>
7. Incremental Revenue Requirements	<u>57.0</u>	<u>48.0</u>	<u>41.9</u>	<u>35.0</u>	<u>27.9</u>

C. SWBT Has Allocated SFAS-106 Costs To The Appropriate Baskets.

The incremental OPEB costs were categorized into the appropriate Part 32 accounts based on existing rules and the interpretations of, or changes to, Part 32 rules contained in RAO Letter 20. Appropriate SFAS-106 amounts were allocated to nonregulated (per Part 64) and other categories (i.e., SNFA and affiliate transactions). The resultant subject-to-separations amounts were apportioned to state and interstate amounts using Part 36 rules. A portion of the SFAS-106 effect was allocated to services not included in the four price cap baskets based on the

²⁶These costs assume a 16-year amortization of the Transition Benefit Obligation. At this time, these estimates assume no prefunding of the OPEB obligation. As SWBT funds the OPEB obligation, the rate base drain shown on line 6 will be lessened, increasing the incremental revenue requirements shown on line 7.

²⁷1992 data is included because SWBT has not yet determined the effective date for SFAS-106 adoption.

²⁸Expenses for life insurance benefits are not literally pay-as-you-go. They are accrued and funded on an actuarially determined basis. (See Section VI, I,2, infra.)

proportion of interstate excluded service revenue to total interstate revenue. SFAS-106 exogenous costs were then allocated to the four price cap baskets and Billing & Collection using Part 69 rules. SWBT's allocations are fully detailed in Exhibit 3.

The following table illustrates the results of the allocations of costs to price cap baskets, excluded services and non-tariffed billing and collection services:

Allocations of SFAS-106 Exogenous Costs to Price Cap Baskets

Basket/Category	Interstate Services
Common Line	42.9%
Traffic Sensitive	31.2%
Special Access	14.4%
Interexchange	3.4%
Excluded Services	0.6%
Billing and Collection	7.5%
Total Interstate	100.0%

Allocations are performed here for 1993 only. The allocations for subsequent years would use the same methods.

D. SWBT Has Disclosed SFAS-106 Information In Reports To The SEC And To Its Owner's Shareholders.

At this time, SWBT has fully complied with all disclosure requirements of the SEC and generally accepted accounting principles for this issue. Accordingly, excerpts from Southwestern Bell Corporation's Annual Reports and all relevant SWBT 10-Q and 10-K reports are attached as Exhibit 4.

SWBT has not made a final decision with regard to the

treatment of SFAS-106 costs for external financial reporting to the SEC and shareholders. Specifically, SWBT has not finalized its decision on whether to immediately recognize or amortize the SFAS-106 Transitional Benefit Obligation (TBO) for external reporting purposes.

E. The Godwins Study Properly Demonstrates That SFAS-106 Costs Should Be Exogenous.

SWBT plans to rely on the analysis contained in the Godwins Study commissioned by USTA (attached as Exhibit 1). The Godwins Study specifically addresses the minor extent to which the increased costs associated with mandatory implementation of SFAS-106 will be reflected in the inflation adjustment mechanism within the Commission's price cap plan for LECs.

The effects of SFAS-106 cannot be recovered by the productivity offset contained in the Commission's price cap plan because the minimum productivity offset is fixed at 3.3%. The studies on which the selection of productivity offset were primarily based used historical LEC data and did not include any of the increased costs of mandatory SFAS-106 implementation.²⁹

Also, because no SFAS-106 costs were included in SWBT's initial price cap rates, no study addressing that issue was relied upon by SWBT. Similarly no SFAS-106 costs have been reflected in any of the exogenous cost adjustments incorporated in any SWBT price cap tariff filing made to date.³⁰

²⁹LEC Price Cap Order, Appendices C and D.

³⁰See Section X, supra.

F. A Proper Study of SFAS-106 Costs Need Not Address Sharing Or Low-end Formula Adjustment Mechanisms.

SWBT will not rely on any studies that might attempt to examine any supposed relationship between SFAS-106 and sharing or low-end formula adjustment mechanisms because no such relationship exists. The Commission imposed sharing and the lower-end formula adjustment mechanism in an abundance of caution, as a regulatory backstop to the productivity offset.³¹ The Commission's orders discussing sharing/low-end adjustments and exogenous cost adjustments never considered relating the operation of exogenous cost adjustments to earnings levels.

The Commission's price cap plan for LECs recognizes most costs as endogenous (under the control of the LEC or fully reflected in the GNP-PI). Certain cost changes are recognized in Section 61.45 of the Commission's Rules as outside the control of LECs and warranting exogenous cost treatment. Both endogenous and exogenous costs are reflected in a price cap LEC's interstate earnings on which sharing and low-end adjustments are calculated. Importantly, however, the intent is to make the effect of exogenous cost changes essentially neutral with respect to earnings.

Thus, the ultimate earnings level experienced by a price cap LEC cannot be directly attributed to the existence of an exogenous cost adjustment. It would be inappropriate to establish an artificial relationship between exogenous cost adjustments and sharing/low-end adjustments.

³¹LEC Price Cap Order, paras. 120-123.